(27)

PETITION AND BRIEF.

FILED
JUN 1 1942
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. [redacted] 109

SWASTIKA OIL AND GAS COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Filed ....., 1942

HARRY C. KINNE,
Attorney for Petitioner,
160 North LaSalle Street,
Chicago, Illinois.

MICHAEL J. SPORRER,
Of Counsel.

U. S. Law Printing Company, 2817 N. Halsted St., Chicago, Ill.

INDEX

PAGE

Petition for writ of certiorari 1-9

Action of the Court below 10

Questions involved 3, 12

Pertinent Statutes to be interpreted 2

Statement of case 3-6

Opinion of the Court below 10

Jurisdiction 10

Specification of errors 11

Argument 11-35

The sum received in settlement constituted *damage to* or *destruction of* petitioner's incorporeal or intangible assets and was therefore not taxable..12-17

The sum received in settlement was not income to taxpayer for the reason that it was in the nature of a penalty assessed against faithless fiduciaries 17

Majority stockholders occupy a fiduciary relationship toward the minority 20-21

A contract entered into between two corporations controlled by the same officers is void for want of mutuality 21-22

The sum received in settlement was not income for the taxable year ended October 31, 1935,

because taxpayer kept its books of account on an accrual basis and taxpayer's right to said sum accrued prior to the year 1935 23-34

FEDERAL CASES CITED

Arcadia Refining Company v. Commissioner, 118 Fed. (2) 1010 31
Brunton v. Commissioner, 42 Fed. (2) 81 32-33
Central Railroad Co. of N. J. v. Commissioner, 79 Fed. (2) 697 ..... 8, 17, 22
Edwards v. Cuba R. R. Co., 268 U. S. 628 19
Eisner v. Macomber, 258 U. S. 189, 207 20
Farmers and Merchants Bank v. Commissioners, 59 Fed. (2) 912 ..... 6, 7, 8, 13, 19
Gould v. Gould, 245 U. S. 151, 153 ..... 16, 18
Heiner v. Hewes, 30 Fed. (2) 787 17
Hort v. Commissioner, 313 U. S. 28 31
Jackson v. Ludling, 21 Wall. 616, 622, 625, 633, 634 21
Jones v. Missouri Edison Electric Co., 144 Fed. 765, 776 21
Liebes v. Commissioner, 90 Fed. (2) 932, 934 ..... 28, 29, 32, 34
Meniers v. Hooper's Tel. Wks. Ltd., 30 Law Times Reports (English) 209 21
North American Oil Consolidated v. Burnet, 286 U. S. 417 32
Saunders v. Commissioner, 29 Fed. (2) 834 17
Southern Pacific Co. v. Bogert, 250 U. S. 486, 487 ..... 20, 22
Southern Pacific Co. v. Bogert, 226 Fed. 500, 226 Fed. 61 21
Spring City Foundry Co. v. Commissioner, 292 U. S. 183, 184, 185 34
Taft v. Bowers, 278 U. S. 470, 473 16

U. S. v. Safety Car Heating and Lighting Co., 297 U. S. 88, 98 ..... 7, 17, 30

FEDERAL STATUTES CITED

Revenue Act of 1934, Sec. 22 (a) 2
Revenue Act of 1934, Sec. 41 ..... 2, 24
Revenue Act of 1934, Sec. 42 ..... 2, 24

STATE COURT CASES CITED.

Coll v. Wells, 224 Mass. 504, 515 21
Carber v. Towne, 208 Mich. 1, 8 21
McKee v. Swenson, 232 Mich. 505 21
Patrons Mutual Fire Ins. Co. v. Holden, 245 Mich. 483, 498 21
Sparrow v. Bement, 142 Mich. 441 21
Voight v. Heinick, 260 Mich. 198, 206 21

BOARD OF TAX APPEALS CASES CITED

In re Brown, 8 B.T.A. 112 25
Byrd v. Commissioner, 32 B.T.A. 568 27
In re Harris, 2 B.T.A. 935 25
In re Midland Valley R. R. Co., 19 B.T.A. 423 26
In re Clarence Schock, 1 B.T.A. 528 24
Selwyn Eddy Co. v. Commissioner, 25 B.T.A. 1341 26
Wilson v. Commissioner, 25 B.T.A. 1280 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

NO.

SWASTIKA OIL AND GAS COMPANY,
Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The above petitioner prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit, entered November 6, 1941, affirming the order of the Board of Tax Appeals holding that the sum of $53,146.52 received by petitioner in settlement of certain litigation during petitioner's fiscal year ending October 31, 1935, was income for that year.

Petitioner's motion for a rehearing seasonably made was denied on March 3, 1942.

STATUTES INVOLVED.

Revenue Act of 1934, C. 277, 48 Stat. 680:

Sec. 22. *Gross Income.*

(a) General definition.—"Gross income" includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * *

(U. S. C., Title 26, Sec. 22.)

Sec. 41. *General Rule.*

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *.

* * *

(U. S. C., Title 26, Sec. 41.)

Sec. 42. *Period in which items of gross income included.*

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

Questions Involved.

A. Was the sum of $53,146.52 received by petitioner in settlement of pending litigation during the fiscal year ending October 31, 1935, compensation for injury to or destruction of incorporeal assets and therefore nontaxable?

B. Was the said sum in the nature of a penalty assessed against faithless fiduciaries and, therefore, nontaxable?

C. Was the said sum taxable for the year 1935, petitioner having at all times kept its books on an accrual basis, and its right to said sum having become absolutely fixed and determined during the year 1933?

The Commissioner of Internal Revenue held that said sum constituted income to petitioner for that taxable year; the Board of Tax Appeals sustained the Commissioner's assessment, and the Circuit Court of Appeals affirmed the order of the Board of Tax Appeals.

Statement.

The facts in this case are not fully set forth in the opinion of the Circuit Court of Appeals (R. 67-71).

The admitted facts are briefly as follows:

The respondent determined a deficiency in the petitioner's income tax returns for the taxable year ending October 31, 1935 (R. 54-56). It was based upon the receipt by the petitioner of a sum in compromise settlement

of litigation pursued by the petitioner in the Circuit Court of Muskegon County, Michigan (R. 6-9). Petitioner has always kept its book on the accrual basis of accounting (R. 3-5). This case was tried before the Board of Tax Appeals (R. 16-32). Respondent offered no evidence other than petitioner's income tax report for its fiscal year ending October 31, 1935 (R. 31, 54-56).

The petitioner, having title to oil lands in Muskegon, Michigan, entered into a contract on April 19, 1929, with one J. D. Wrather, for the building of a refinery thereon, to cost $75,000.00 (Pet. Ex. 1, R. 23, 24, 36, 38). By its terms the petitioner was to sell Wrather all of the crude oil produced by its wells with an agreement that whenever the cost of the refinery should be paid out of the profits of its operation the petitioner was to receive a 35 per cent interest therein, and if a corporation was organized to take it over, it was to receive 35 per cent of its stock (R. 23, 24). Wrather built the refinery and transferred it to a corporation styled the Michigan Central Refining Company, a Michigan corporation, in which defendants Wrather, Maguire and Caldwell were controlling stockholders, directors and officers (Pet. Ex. 1-2, R. 24, 38, 39). The corporation assumed Wrather's contract with petitioner. The petitioner furnished it with oil until May 28, 1930, when Wrather and his fellow controlling stockholders, directors and officers, Caldwell and Maguire, secretly caused the Michigan Central assets to be transferred to the Roosevelt Oil Company (in which Maguire and Caldwell were also the controlling stockholders, directors and officers), the refinery to be moved from Muskegon, Michigan, to Mt. Pleasant, Michigan, and the Michigan Central Refining Company to be dissolved (R. 24-26). Later Maguire and Caldwell secretly caused the Roosevelt Oil Company to enter into contracts for the sale and distribution of its

products to and through the Simrall Pipe Line Company and the Northland Oil Company, other corporations which they also controlled, resulting in large secret profits to them and their nominees.

Wrather, Maguire and Caldwell, as majority stockholders, directors and officers of both the Michigan Central Refining Company, the seller, and the Roosevelt Oil Company, the buyer, occupied a fiduciary relationship toward petitioner (Plf. in the Michigan court).

At the time of the removal of the refinery from Muskegon, $39,000.00 of its original cost had been paid out of the profits of the Michigan Central Refining Company earned in 1929 and 1930 (R. 25). The remaining $36,000.00 was paid out of the profits of the Roosevelt Oil Company in the period 1930 to 1933 (R. 18, 28, 29).

The Roosevelt Oil Company, which took over the assets of the Michigan Central Refining Company, showed by its financial statement for September, 1933, total assets of approximately $493,000.00 (Pet. Ex. 10, R. 29, 52-54). Petitioner's interest in said Roosevelt Oil Company was reasonably worth $90,000.00 at that time (R. 30).

On May 19, 1931, the petitioner filed a bill of complaint in equity in the Circuit Court of Muskegon County, Michigan, seeking to impress a trust upon the capital stock of of the Roosevelt Oil Company to the extent that it was entitled to have received stock in the Michigan Central Refining Company. In the alternative it sought to set aside the dissolution of the Michigan Central, to procure the transfer to it of all of the Roosevelt Oil Company assets, and the execution and delivery to the petitioner of its agreed share of Michigan Central capital stock. It

also sought an accounting on behalf of Michigan Central of the secret profits made by the promoters in the transactions between Roosevelt Oil Company and other corporations (Pet. Ex. 1-7, R. 32-43). The trial court filed his opinion on January 23, 1935 (Pet. Ex. 8, R. 43-48), and a decree followed on February 28, 1935, substantially granting the petitioner's claim to relief (Pet. Ex. 9, R. 48-52). The dissolution of the Michigan Central Refining Company and the sale of its assets, were held null and void, and the plaintiff adjudged entitled to 35 per cent of the shares of Michigan Central stock and *that company* was held to be entitled to an accounting of the profits derived by the Roosevelt Oil Company, and the other companies controlled by defendants, Maguire and Caldwell (Pet. Ex. 9, R. 48-52).

The defendants in the state court litigation prepared to take an appeal to the Michigan Supreme Court, but later agreed upon a settlement pursuant to which the petitioner, in September, 1935, received a cash payment of $80,000.00 in full settlement of its claims. The respondent allowed a deduction of the legal and other expenses incurred in the prosecution of the suit; and asserted a deficiency in the petitioner's taxable income for 1935 of $53,146.52. This deficiency was contested before the Board of Tax Appeals which sustained the Commissioner. On petition for review of the Board's decision (R. 57-63) the Circuit Court of Appeals affirmed the same (R. 67-71).

Reasons For Granting the Writ.

1. In the case of *Farmers and Merchants Bank* v. *Commissioner*, 59 Fed. (2) 912, Mr. Justice Hicks, speaking for the Circuit Court of Appeals for the Sixth Circuit, said

"We can see no legal distinction between compensation for *destruction of* or *damage to* incorporeal or intangible property" and held that an amount received in settlement of a *tortious injury* to one asset (good will) of a taxpayer does not constitute income upon any logical basis. On the contrary Mr. Justice Simons, speaking for the same court in the case at bar, holds that a *total destruction* of another incorporeal or intangible asset (right to receive stock in a company tortiously dissolved) does constitute income. In other words, an amount received in settlement for *an injury to an asset* is not income, while a like settlement for the *total destruction of an asset* is income.

2. The opinion of the Circuit Court of Appeals in the case at bar is directly in conflict with the opinion of this court in the case of *U. S.* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, where it said on page 98:

> "The case is not to be confused with one where the basis of the suit is an injury to capital with the result that recovery is never income no matter when collected."

3. In the case of *Central Railroad Co. of N. J.* v. *Commissioner*, 79 Fed. (2) 697, where the material facts and legal principles involved are practically identical with those in the case at bar, the Circuit Court of Appeals for the Third Circuit, specifically approved and followed the decision of the Sixth Circuit in the *Farmers & Merchants Bank* case, 59 Fed. (2) 912, quoted Mr. Justice Hick's language "The fund involved must be considered in the light of the claim from which it was realized", and thereupon held that the amount received in settlement of a suit against faithless fiduciaries in that case did not constitute income because it was in the nature of a penalty assessed against faithless fiduciaries. Both the Board of Tax Ap-

peals and the Circuit Court of Appeals entirely overlooked the *Central Railroad Company* case.

4. There is no difference between the fiduciary relationship which existed between Joyce as managing agent of the Central Railroad Company of New Jersey, 79 Fed. (2) 697, who organized secret companies to deal with his own company, and that fiduciary relationship which existed between petitioner and Maguire, Caldwell and Wrather, who wrecked, destroyed and illegally dissolved the Michigan Central Refining Company, of which they were majority stockholders, directors and controlling officers, by secretly selling that company's assets to the Roosevelt Oil Company, which they also controlled in a like manner. Furthermore they injured, yes, *destroyed,* the capital stock in Michigan Central Refining Company to which plaintiff was legally entitled to the same extent that the defendant in the *Farmers & Merchants Bank* case 59 Fed. (2) 912 injured the latter's good will.

The decision of the Circuit Court of Appeals for the Third Circuit in the case of *Central Railroad Company of New Jersey* v. *Commissioner,* 79 Fed. (2) 697 holding that money recovered from a faithless fiduciary does not constitute income is directly in conflict with the decision of the Sixth Circuit in the case at bar.

5. Although it is admitted and the Circuit Court of Appeals states (R. 70) that petitioner kept its books on an accrual basis, and although it is admitted and that Court states (R. 68) that the profits of the Roosevelt Oil Company absolutely entitled petitioner to 35 per cent of the Michigan Central stock as early as the year 1933 yet the Circuit Court of Appeals holds that the amount received for the stock to which it was admittedly entitled in 1933 was income in 1935 (R. 69).

6. The decisions of the several Circuits of the Court of Appeals already rendered on the material questions of evidence and law involved here are confusing, difficult, if not impossible, of reconciliation and do not appear to be applying uniform tests of principle.

7. This Court has never decided whether an amount received by a taxpayer in settlement of a suit brought for the recovery of property misappropriated by faithless fiduciaries constitutes income.

Wherefore, it is respectfully submitted that this petition should be granted.

SWASTIKA OIL & GAS COMPANY,
By HARRY C. KINNE,
Its attorney.

HARRY C. KINNE,
Attorney for Petitioner
1629-160 N. LaSalle St.
Chicago, Illinois

MICHAEL J. SPORRER,
Of Counsel
Majestic Building
Milwaukee, Wis.

Petitioner's Brief in Support of Petition for Writ of Certiorari.

Opinion of the Circuit Court of Appeals for the Sixth Circuit.

The opinion in this case has not yet been officially reported. It appears on pages 67 to 71 of the record. The decision of the Board of Tax Appeals is reported in 40 B. T. A. 119.

Jurisdiction.

The judgment of the Circuit Court of Appeals was rendered on November 6, 1941 (R. 67). A petition for a rehearing was seasonably filed on December 2, 1941 (R. 72-79), was duly entertained and was denied on March 3, 1942 (R. 81). Jurisdiction to issue the writ is conferred by Section 240 of the Judicial Code as amended by Section 3 (b) of the Act of Congress of February 13, 1925 (43 Stat. 938, Par. 1-7, Rule 38 Supreme Court).

Questions Involved.

The questions at issue are fully set forth on page 3 of the petition preceding this brief.

Statutes Involved.

The pertinent Statutes to be interpreted are set forth on page 2 of the petition.

Statement.

A complete statement of the case likewise appears on pages 3 to 6 of the petition.

Specification of Errors.

I. The Circuit Court of Appeals erred in refusing to find that the sum received by taxpayer in settlement constituted *damage to* or *destruction of* petitioner's incorporeal or intangible assets and was therefore not taxable.

II. The Circuit Court of Appeals erred in refusing to find that the sum so received in settlement was not income to taxpayer for the reason that it was in the nature of a penalty assessed against faithless fiduciaries.

III. The Circuit Court of Appeals erred in refusing to find that the sum so received in settlement was not income for the taxable year ended October 31, 1935, because taxpayer kept its books of account on an accrual basis and taxpayer's right to said sum accrued prior to the year 1935.

ARGUMENT.

The Circuit Court of Appeals erred in stating in the first paragraph of its opinion (R. 67) that the two questions at issue in this case are (1) "whether the payment was income or the restoration of a capital loss" and (2) "whether the payment was income in the tax year when it was received (1935), or, the taxpayer making return

upon the accrual basis, the payment was income in the year when the claim arose."

The real questions involved are set forth in the petition namely:

A. Was the sum of $53,146.52 received by petitioner in settlement of pending litigation during its fiscal year ending October 31, 1935, compensation for injury to capital and therefore non-taxable?

B. Was the said sum in the nature of a penalty assessed against faithless fiduciaries and, therefore, non-taxable?

C. Was the said sum taxable for that year, petitioner having at all times kept its books on an accrual basis, and its right to said sum having become absolutely fixed and determined during the year 1933?

The Amount for Which the Litigation in Question Was Settled Did Not Constitute Income for the Fiscal Year ended October 31, 1935, Under Any Circumstances Because it Was Compensation for Injury to or Destruction of Capital.

The facts are undisputed. The Circuit Court of Appeals for the Sixth Circuit to which the writ of certiorari should be directed has previously said in the case of *Farmers & Merchants Bank* v. *Commissioner,* 59 Fed. (2) 912, on page 913, speaking through Mr. Justice Hicks, that, "We can see no legal distinction between compensation for *destruction of* or *damage to* incorporeal or intangible property such as good will." However, in the case at bar,

that same Court, speaking through Mr. Justice Simons, holds that *destruction of* or *damage to* petitioner's right to receive 35 per cent of the capital stock of the Michigan Central Refining Company should be denied on the theory that it constitutes profit.

In the fifth paragraph of the opinion (R. 69-70) the Circuit Court of Appeals quotes its own language from the *Farmers and Merchants Bank* case, as follows: "The fund involved must be considered in the light of the claim from which it is realized," but has entirely overlooked its own language first above quoted from that case.

Petitioner's right to 35 per cent of the capital stock of the Michigan Central Refining Company was fixed by the Wrather-Swastika contract (Pet. Ex. 1, R. 23, 24, 36, 38), and became absolute and final in 1933 (R. 18, 28, 29). Instead of giving petitioner the stock to which it was entitled defendants Wrather, Maguire and Caldwell, the controlling stockholders and directors and the only officers of the Michigan Central Refining Company pretended to sell Michigan Central's entire assets to the Roosevelt Oil Company, of which Maguire and Caldwell were also the controlling stockholders and directors and the sole officers (R. 24-26).

Thereupon Maguire and Caldwell dissolved the Michigan Central Refining Company and surrendered its charter and proceeded to transact its business at Mount Pleasant, Michigan in the name of the defendant Roosevelt Oil Company all without the knowledge of petitioner and its officers. No plainer case could possibly be presented of *damage to or rather destruction of a taxpayer's incorporeal or intangible asset* the right to receive said stock.

The Sixth Circuit further said on page 913 of the *Farmers and Merchants Bank* case:

> "We find nothing therein to indicate, with the certainty required in the statement of a cause of action, that the petitioner sought reparation for profits which defendant's misconduct prevented it from earning in 1925. We think, therefore, there is no logical basis upon which petitioner could be charged with gain. See *Strother* v. *Commissioner,* 55 Fed. (2) 626, 633. *One may be recompensed for an injury, but it is a rare case in which one should have a profit out of it.* The order of the Board of Tax Appeals is reversed." (Italics ours.)

The facts in the bank case are identical in principle with the facts in the case at bar, although the litigation in the Muskegon County Circuit Court involved the destruction of capital rather than an injury to same. In other words, the case at bar is one step further removed from income than the bank case. By their fraudulent actions, the individual defendants in the case at bar definitely destroyed a part of petitioner's capital (the 19,480 shares of capital stock in the Michigan Central Refining Company) by illegally dissolving that company and diverting its assets.

Following the statement in the opinion here (R. 69-70), that "the fund involved must be considered in the light of the claim for which it is realized," it becomes necessary to examine the pleadings in the case of *Swastika Oil and Gas Company* v. *Michigan Central Refining Company, et al,* in the litigation heretofore pending in the Circuit Court of Muskegon County. Particularly is it necessary to examine the bill of complaint (Pet. Ex. 1, R. 32-39), the opinion of that court preceding its decree (Pet. Ex. 8, R. 43-48), and the decree itself (Pet. Ex. 9, R. 48-52). Nowhere does it appear, nor can it be presumed that the

litigation was instituted for the purpose of determining the income of or obtaining income for the plaintiff there (petitioner here). An examination of the prayer of the bill of complaint plainly shows that petitioner thereby sought to have the Michigan Central (the company in which petitioner was to procure a 35 per cent interest) rehabilitated, its dissolution cancelled, all of the Roosevelt Oil Company's property transferred and conveyed to Michigan Central, and to have 10,480 shares of the latter company's capital stock transferred to petitioner. Petitioner also sought an accounting *only upon behalf of Michigan Central and not upon behalf of petitioner here.*

By an examination of the decree (Pet. Ex. 9, R. 48-52), it will be seen that the court (1) sets aside the purported dissolution of Michigan Central (R. 48), (2) directs the calling of a stockholders' meeting thereof for the election of directors and the subsequent calling of a directors' meeting to elect officers thereof, (3) directs the issuance of 10,480 shares of capital stock to petitioner, (4) finds the purported sale of the assets of Michigan Central to the Roosevelt Oil Company null and void, (5) directs the conveyance of all of the Roosevelt's property to Michigan Central (R. 49), (6) orders an accounting by the Roosevelt, the Simrall Pipe Line Company and the Northland Oil Company *to Michigan Central,* (7) orders an accounting by the individual defendants to *Michigan Central* as well as an accounting by all companies subsidiary to the Roosevelt to *Michigan Central,* and enjoins the selling, incumbering or other disposition of the assets of any of the defendant companies (R. 51), and (8) retains jurisdiction of the case for further disposition (R. 52).

The opinion of the court (Pet. Ex. 8, R. 43-48) sets forth in more detail the evidence upon which the decree is based.

Therefore the proceedings in the Muskegon Court were in the nature of an action to restore capital assets rather than obtain income, in the nature of a suit to compel faithless fiduciaries (Maguire, Caldwell, Wrather and their nominees) to account to Michigan Central *and not to petitioner,* as the opinion states at the end of the third paragraph (R. 69).

In the case of *Taft* v. *Bowers,* 278 U. S. 470, this Court said on page 473:

> "So far as B is concerned, he has an actual economic gain of $200.00, but it has long ago been settled that an economic gain is not necessarily a taxable gain in the constitutional sense." Citing *Gould* v. *Gould,* 245 U. S. 151; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *U. S.* v. *Oregon Washington R. R. Co.,* 251 Fed. 211.

In the case of *Gould* v. *Gould,* 245 U. S. 151, this court said on page 153:

> "*In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen.*" Citing *U. S.* v. *Wigglesworth,* 2 Story 369; *American Net and Twine Co.* v. *Worthington,* 141 U. S. 468, 474; *Benziger* v. *U. S.,* 192 U. S. 38, 55, and many other cases. (Italics ours.)

In no sense of the word could the results of petitioner's litigation in the Muskegon Court constitute *"gross revenue derived from the operation and management of the business and property of the petitioner."*

In the case of *U. S.* v. *Safety Car Heating and Lighting Co.*, 297 U. S. 88, this court said on page 98:

> *"The case is not to be confused with one where the basis of the suit is an injury to capital with the result that recovery is never income, no matter when collected.* Examples of such claims are *Saunders* v. *Commissioner*, 29 Fed. (2) 834, and *Heiner* v. *Hewes*, 30 Fed. (2) 787." (Italics ours.)

The Amount Received Was Also a Penalty Imposed by Law Upon Faithless Fiduciaries and, Therefore, Not Taxable as Income.

In the case of *Central Railroad Co. of N. J.* v. *Commissioner*, 79 Fed. (2) 697, Third Circuit, Henry L. Joyce was for a number of years prior to 1921 an executive officer of the taxpayer (Central R. R. Co.) in charge of its New York marine department. He was entrusted with considerable responsibility and authority. While he was so employed he and one Harry B. James organized certain corporations for the purpose of carrying on business operations surreptitiously, which operations were adverse to the interests of taxpayer company. Joyce, through his position with his company, caused to be made certain leases between said corporations and taxpayer, which leases were advantageous to and for the benefit of himself and his associate, James, through their said corporations. Taxpayer brought a suit in equity against Joyce and his associates and their corporations on the theory that he

and his associates had conspired to defraud the taxpayer company, and *seeking an accounting for profits earned by the corporations or to recover damages sustained by the taxpayer company* in entering into the above contracts and agreements with Joyce's corporations. In June, 1928, the suit was settled before coming to trial, and the taxpayer received *property* admittedly worth $456,405.00. The taxpayer did not include this property in its income tax for the year 1928, the taxable year in question. The Commissioner of Internal Revenue determined that the above sum should have been included in the gross income of the taxpayer company for that year. The Board of Tax Appeals approved the Commissioner's ruling. On page 698 that court, in defining income within the meaning of Section 22 (a) of the Revenue Act of 1928, said:

> " 'Gross income' includes gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce or sales or dealings in property, whether real or personal, growing out of the ownership or use or interest in such property; also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profit and income derived from any source whatever."

The court there held that not all property received as a result of litigation is income, such as alimony and separate maintenance allowances to which *complaint would be equitably entitled in such suits;* damages recovered for alienation of affections, breach of promise to marry, and libel and slander are not taxable. Damages recovered because of personal injuries or illness are exempt. Citing Rev. Act of 1928, Sec. 22 (b), regulation 22, article 82, and *Gould* v. *Gould,* 245 U. S. 151. A recovery in such actions is compensatory and in payment of injuries sustained.

On page 698, that court cited the case of *Edwards* v. *Cuba Railroad Co.,* 268 U. S. 628, wherein it was held that the subsidies paid by government to a railroad and conditioned upon the completion of certain construction did not constitute taxable income.

That court also cited the above case of *Farmers & Merchants Bank* v. *Commissioner,* 59 Fed. (2) 912, 913, Sixth Circuit, where it was held that money received in the settlement of a suit by the bank for damages done *to the good will of its business was not taxable.* The court further said that the suit in the Bank case was not to recover *the loss of profits but to recompense the bank for injury to its business.*

The court further said on page 698:

> "As the court said in the *Farmers & Merchants Bank* v. *Commissioner* case, *supra,* the value of the property involved here *must be considered in the light of the claim from which it was realized.*" (Italics ours.)

On page 699 the court further said:

> "It is apparent then that income must come from capital or labor or both, including gains from the sale of assets. That being so, the value of the property which the taxpayer received cannot be traced to either capital or labor. As the tax payer said in the paragraph quoted above, what it received was in the nature of a 'windfall.' *It was a penalty imposed by the law on a faithless fiduciary, a gain granted gratuitously because of the necessity of keeping persons in positions of trust beyond the temptation of double dealing.* It cannot be said that it was derived wholly or in part *from the use of taxpayer's capital or labor.* The nearest that one can come to that is to say that Joyce and his dummies could not have operated but for Joyce's position with the tax payer, and its type of business. *But Joyce's ultra vires operations were not carried on by the use of capital and labor. They were entirely separate and apart from its business construction.*

Moreover, the settlement was not based on suit by the tax payer to recover profits of which it had been deprived." (Italics ours.)

The court cited in support of its opinion a number of cases including the case of *Eisner* v. *Macomber,* 252 U. S. 189, 207, where this court said on page 207:

"Income may be defined as the gain derived from capital, from labor, or both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."

The Board of Tax Appeals entirely overlooked the *Central Railroad Company* case in its opinion, although it was specifically called to the Board's attention (R. 13-32). The Sixth Circuit did likewise.

Majority Stockholders Have a Right to Control a Corporation's Acts But When the Majority Does so Control They Occupy a Fiduciary Relationship Toward the Minority. The Majority Constitute a Trustee for the Minority and the Burden is Upon the Former to Prove That Their Acts Are Fair to the Minority.

In the case of *Southern Pacific Co.* v. *Bogert,* 250 U. S. 486, this court said on page 487:

"The majority (of stockholders) has the right to control; *but when it does so, it occupies a fiduciary relation toward the minority;* as much so as the corporation itself or its officers and directors. *If, through that control, a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale.*" (Italics ours).

See also *Southern Pacific Co.* v. *Bogert,* 226 Fed. 500, 244 Fed. 61, and a host of other decisions beginning with *Menier* v. *Hooper's Telegraph Works Ltd.,* 30 Law Times Reports (English) 209, 22 Weekly Reported 396; *Jackson* v. *Ludling,* 21 Wall. 616, 622, 625, 633, 634.

A Contract Entered Into Between One Corporation Controlled By Certain Officers and Directors and Another Corporation Controlled by the Same Officers and Directors is Absolutely Void for Want of Mutuality.

In the case of *Sparrow* v. *Bement,* 142 Mich. 441 the court said on page 453:

> "The interest of the two companies was adverse, one being vendor, the other purchaser. *By this agreement the same individuals represented both parties and in one capacity contracted with themselves in another capacity. As directors of the new company they were the beneficiaries and no one representing the old company was left to protect its interests.*
>
> The agreement was void for want of parties. *Miner* v. *Ice Co.,* 93 Mich. 97, 109, 110, where it was said:
>
> '*All the authorities agree that it is essential that a majority of the quorum of the board of directors shall be disinterested in respect to the matters voted upon.*' "
> (Italics ours)

See also the cases of *McKee* v. *Swenson,* 232 Mich. 505; *Voight* v. *Hemick,* 260 Mich. 198, 209; *Carber* v. *Town,* 208 Mich. 1, 8; *Patrons Mutual Fire Ins. C.* v. *Holden,* 245 Mich. 493, 498; *Coll* v. *Wells,* 224 Mass. 504, 515.

In the case of *Jones* v. *Missouri Edison Electric Co.* 144 Fed. 765, the court said on page 776:

> "The gravamen of this bill is the deprivation of the complainant and those stockholders who unite with him, of their just share of the property of the Edison Company."
>
> *Bogert* v. *Southern Pacific*, 250 U. S. 486.

The litigation in the case of *Swastika* v. *Michigan Central Refining Co., et al*, involved the identical issues set forth in the case of *Central Railroad Co. of N. J.* v. *Commissioner*, 79 Fed. (2) 697, Third Circuit. Therefore, the proceeds of the settlement of that suit did not constitute income.

A fiduciary relationship existed between Maguire, Caldwell, Wrather and petitioner, to the same extent as that which existed between the railroad and Joyce in the Central *Railroad Company* case. In fact, the case at bar is further removed from the question of profits than the railroad case. Joyce was the agent of the railroad, while there is no question of agency in the case at bar. Joyce, through his secret ownership of other companies dealing with his employer, the railroad, was obliged to *pay over his secret profits to his employer.* The fiduciary relationship existing between Maguire, *et al*, and petitioner constituted a basis for setting aside the destruction and dissolution of the Michigan Central in which petitioner was to procure stock. It necessarily follows that the principles of law announced in the *Central Railroad Company* case apply here. The final decree entered by the Muskegon Court *was in the nature of a penalty imposed by law on faithless fiduciaries, a gain granted gratuitously because of the necessity of keeping persons in positions of trust beyond the temptation of double dealing.* These issues here fall within the very language of the Third Circuit on page 699 of the Central Railroad Company decision. It cannot be said in the case at bar that the results of the litigation in the

Muskegon Court were derived wholly or in part from the use of petitioner's capital or labor. Maguire, Caldwell, Wrather, and their associates *could not have operated but for their fiduciary relationship with the tax payer and their ability to convert the assets of petitioner.* Furthermore, as was said in the *Central Railroad Company* case, the operations of Maguire, *et al,* as fiduciaries *were not carried on by the use of petitioner's capital and labor.* Their operations were carried on by absolutely destroying Michigan Central and thereby proportionately destroying petitioner's assets. Those fiduciaries, as well as their various companies were entirely separate and apart from petitioner's business.

The Amount So Received in Settlement Was Not Income for the Taxable Year Ended October 31, 1935, Because Taxpayer Kept Its Books of Account on an Accrual Basis and Its Right to Said Sum Accrued Prior to the Year 1935.

By reason of the fact that petitioner kept its books of account on an accrual basis the interest to which it was entitled in the Michigan Central Refining Company, or the Roosevelt Oil Company, was income prior to the year 1935, if it was income at all. Said interest was definitely known to have accrued to petitioner and said interest was definitely established and determined long prior to the year 1935, all pursuant to the terms of the Wrather-Swastika contract.

Respondent does not deny and both the Board of Tax Appeals and the Circuit Court of Appeals (R. 70) spe-

cifically found that petitioner kept its books on an accrual basis for all years up to and including 1935. Walter H. Koelbel, Secretary of petitioner, so testified (R. 17).

Section 42, Revenue Act of 1934, provides:

> *"The amount of all items of gross income shall be included in the gross income for the taxable year in which received* by the taxpayer, *unless* under methods of accounting permitted under Section 41 any *such amounts are properly accounted for as of a different period."* (Italics ours).

Section 41 provides in part:

> *"The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer * * *."* (Italics ours).

The basic idea of the accrual system of accounting is that *the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned regardless of whether payments have been made or are due.* Expenses incurred in operations for a particular year are properly held to have accrued in the accounts for that year *although payment may not be due until the following year.*

The word "accrue" under the accrual system of accounting *does not mean that the items are due in the sense that they are then payable.* The Board of Tax Appeals, itself, has laid down this rule in a long line of decisions beginning with the early case of Clarence Schock, 1 B.T.A. 528. The taxpayer in that case and his partners stipulated that they would take no salary or drawing account until they should all agree that the company's credit

condition would warrant it. Books were kept on the accrual basis. *The company credited taxpayer's account but he did not receive any money.* The Board said on page 530:

> "Under such a system of accounting (accrual) *receipt of income—actual or constructive—is not essential to constitute it income within the statutory definition of income.* Under an accrual system of accounting, one *accrues* income, he does not *receive* it. Under the receipts and disbursements method, one *receives* income and does not *accrue* it." (Italics ours).

In the case of *S. W. Harris,* 2 B.T.A. 935, taxpayer bought cotton in the United States on his own account and with his own money, and shipped it to England, where a firm sold the cotton, and after deducting all expenses credited him with the profit. Taxpayer had no control over the cotton after it was shipped, or the price for which it should be sold. The English firm refused to let him draw against the account so as to reduce it below fifteen thousand pounds, retaining this amount to cover possible losses and for possible claims for English taxes.

The Board said on page 936:

> "The taxpayer contends that the profit credited to his account on the books of Braun & Glazebrook, as of July 31 of each year were neither actually or constructively received by him. As the taxpayer's books were kept on the accrual basis, that argument is specially answered in the appeal of *Clarence Schock,* 1 B.T.A. 528, in which we held that *under the accrual system of accounting, receipt of income, actual or constructive, is not essential to constitute it income within the statutory definition thereof.*" (Italics ours.)

See also the case of *In re Brown,* 8 B.T.A. 112 (acquiesced in by the Commissioner).

In the case of *Wilson* v. *Commissioner,* 16 B.T.A. 1280, the Board said on page 1288:

> "It is true, of course, that *the partnership never received the amount of this commission,* but in an accrual system of accounting the accrual of an amount *does not depend upon actual receipt,* Ernest M. Bull, Executor, 7 B.T.A. 993, *but rather upon the fact that in all reasonable probability the amount will be received.*" (Italics ours).

The undisputed evidence shows that petitioner here was actually and definitely entitled to its interest as early as the year 1933 (R. 30). Therefore, *"in all reasonable probability" the stock should have been received and the right to it accrued in* 1933. See also the case of *Midland Valley R. R. Co.,* 19 B.T.A. 423.

In *Selwyn Eddy Co.* v. *Commissioner,* 25 B.T.A. 1341, the Board said on pages 1347 and 1348:

> "The basic idea underlying the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned. *It is not necessary that the amount of such items be exactly ascertained in order to accrue them, if a mere calculation or computation based on ascertained factors is all that remains to be done. H. H. Brown Co.,* 8 B.T.A. 112. In the instant case we are not informed as to when the computation of the amount received by the petitioner was made. However, that is not important since we know that the right to receive such amount became fixed and determined prior to 1920. *In our opinion the petitioner's right to receive the payments here involved accrued prior to* 1920. Consequently, the amount accrued prior to that year, *even though it may not have been exactly ascertained until during* 1920.

> "Since the amount accrued prior to 1920, it becomes unnecessary to determine whether it constitutes income as contended for by the respondent or was a return of capital as contended by the petitioner. In any event, it would not be taxable in 1920." (Italics ours.)

"A mere calculation or computation" of the profits of the refinery as shown by the undisputed evidence was all that was required to establish petitioner's right under the Wrather-Swastika contract to receive, even prior to 1933, 35 per cent of the capital stock of the Michigan Central Refining Company.

In the case of *D. H. Byrd* v. *Commissioner,* 32 B.T.A. 568, it appeared that in 1931 the petitioner there became entitled, without restriction, to one-half of the net profits of a partnership or joint venture of which he was a member. The Board held that the petitioner there was taxable for that year upon the full amount of his distributable share of such partnership or joint venture profits, *notwithstanding litigation was then pending upon a claim against one-half thereof, which litigation was finally terminated adversely to petitioner in* 1933.

The fact that petitioner here was obliged to proceed in equity to obtain its rights has no bearing in this case.

In spite of the plain, unequivocal language used by the Board of Tax Appeals in the above cases, in spite of the express finding by the Circuit Court of Appeals (R. 70) that "Petitioner kept its books as indicated on an accrual basis" and in spite of the following express finding of the Muskegon Court in the fraud suit quoted on pages 2 and 3 of the Board's opinion:

> "It appears clear that at the time of the fraudulent sale of the Refinery's assets to Roosevelt, the defendant Wrather's account for the erection of the Refinery equipment at Muskegon had been paid down to $39,000.00, by reason thereof plaintiff was entitled to one-half of the capital stock in the Refinery, in accordance with the Swastika-Wrather contract, and that after the fraudulent sale and subsequent to the removal of the Refinery equipment to Mt. Pleasant, the Refinery under the name of Roosevelt Oil Company, paid to Wrather his entire account for the erection of the refinery equipment at Muskegon." (R. 46)

the Circuit Court of Appeals held that the sum received by petitioner was income for the year 1935.

By the very terms of the Wrather-Swastika contract (Plf. Ex. 1, R. 23, 24, 36, 38), and by the undisputed evidence proving that the refinery was fully paid for prior to 1933 (R. 18, 25, 28, 29), "petitioner had a fixed and unconditional right" to 35 per cent of the capital stock of the Michigan Central Refining Company prior to the year 1935. *To recover this very stock petitioner brought suit* in the Circuit Court of Muskegon County.

In the case of *Liebes* v. *Commissioner,* 90 Fed. (2) 932, cited in the opinion here (R. 70, 71), the question arose as to when the alleged income charged to the petitioner in that case accrued, or in other words, when said alleged income should have been reported. On May 23, 1927, judgments were entered in favor of plaintiff there for approximately $106,000.00, which plaintiff collected in 1930 and failed to include in its income tax report for that year. *The court held on page* 934 *that in the absence of proof it cannot be presumed that a taxpayer kept its books on an accrual basis,* citing *Niles Bennett Pond Co.* v. *U. S.,* 281 U. S. 357, 361. In the case at bar it is an undisputed fact that petitioner kept its books at all times on an accrual

basis (R. 17). The Circuit Court of Appeals itself, so found in its opinion (R. 70).

In the *Liebes* case the court further said on page 934:

> "It is true that the record does not disclose upon which basis petitioner accounted, that is, whether it used an accrual basis, or a cash basis. If petitioner made its returns on a 'cash' basis, it is obvious that the Board's decision was correct for the income was received during the fiscal year ending January 31, 1930. On the other hand, if petitioner reported on the 'accrual' basis, then we must decide whether or not the income received during the fiscal year ending January 31, 1930, *also accrued during that year.* * * * The complete definition would, therefore, seem to be that income accrues to a taxpayer when there arises to him a fixed or unconditional right to receive it, *if there is a reasonable expectancy that the right will be converted into money or its equivalent.*" (Italics ours.)

At least as early as 1933 there arose to petitioner "*a fixed or unconditional right to receive*" the stock.

It is an undisputed fact that the September, 1933, statement of the Roosevelt Oil Company, itself, (Pet. Ex. 10, R. 52-54) conclusively proves that petitioner here was entitled to thirty-five per cent (35%) of the capital stock of Michigan Central or the Roosevelt Company as early as the year 1933, two years prior to the year in which the final settlement was made. Both the opinion and the decree of the Muskegon Court (Pet. Exs. 8, 9, R. 43-52) so held. Under no theory could the item of $53,146.52 be considered income for the year ended October 31, 1935, under the accrual system of accounting.

Furthermore, the undisputed testimony proves, and the opinion here expressly finds (R. 70) that Michigan Cen-

tral, before the refinery was moved to Mt. Pleasant, had made profits sufficient to reduce the cost of the refinery from $75,000.00 to $39,300.00. The undisputed evidence also proves that the refinery thereafter made profits of $1,105.00 in 1930, $54,899.00 in 1931, and $50,100 in the year 1932. Under any theory, petitioner would have been entitled to thirty-five per cent (35%) of the stock in the Michigan Central Refining Company during the year 1931 (R. 29).

The findings by the Circuit Court of Appeals (R. 70-71) that petitioner could not know whether it would be successful in obtaining an adjustment is contrary to the facts and the law in this case.

The case of *U. S.* v. *Safety Car Heating Company*, 297 U. S. 88 (R. 70-71), involved a suit by the owner of a patent to restrain infringements and for damages and profits. *The owner waived his claim for damages and pursued his claim for profits.* Pending an appeal by the infringer involving the extent of his liability a compromise occurred in which the patent owner accepted a smaller sum in satisfaction of the judgment.

This court held that the *profits* thus received accrued to the patent owner and became taxable as income at the time of settlement and liquidation (page 93). There is no question of the recovery of profits in the case at bar.

This Court in clearly distinguishing a conditional claim from an unconditional one said on page 95, "a claim existing 'unconditionally' would include a claim for interest on a bond or for rent under a lease. A claim existing conditionally can have no better illustration than is found in a claim to recover an infringer's profits."

Petitioner's right to the Michigan Central stock was as unconditional as a claim for rent under a lease.

The opinion (R. 70) relies upon the case of *Arcadia Refining Company* v. *Commissioner,* 118 Fed. (2) 1010, Fifth Circuit, to sustain the alleged doctrine that "there are cases where compensation for loss of or injury to capital may be measured by lost profits as in the case just cited" (*Farmers and Merchants Bank* case). Such was not the decision of the Sixth Circuit in that case. The injury there was to good will. In fact the Court on page 913 specifically stated that there was nothing in the pleadings in the bank case to indicate that the bank was there suing for lost profits.

The opinion endeavors to distinguish between an injury to capital and a default in the payment of money or delivery of property, and holds that the settlement in the case at bar applies to the latter. In the *Arcadia* case the Fifth Circuit specifically found on pages 1010-11, that $21,260.18 of the $105,000.00 received in settlement represented return of capital and no tax was levied against the first sum. The undisputed evidence in the *Arcadia* case shows that the remaining portion of the amount received in settlement constituted profits for the year 1935. Therefore, the decision of the Fifth Circuit in the *Arcadia* case is directly in conflict with the Sixth Circuit's decision in the case at bar, in so far as the taxability of an amount received in lieu of the return of capital is concerned. Furthermore, the decision in the *Arcadia* case is in direct conflict with that of the Third Circuit in the *Central Railroad Company* case, because in both cases the recovery was based upon the unlawful acts of faithless fiduciaries.

The case of *Hort* v. *Commissioner,* 313 U. S. 28, cited in the opinion (R. 70), has no bearing whatsoever on the case at bar for the reason that this Court there decided

the question of the taxability of an amount received for the cancellation of a long term lease. The case of *Liebes* v. *Commissioner,* 90 Fed. (2) 932, Ninth Circuit, does not support the opinion for the reason that the Court in the *Liebes* case held specifically that the damages awarded to the taxpayer which was held subject to tax included profits.

The confusion of the Circuit Court of Appeals is plainly shown by the statement in the opinion that "perhaps too much emphasis should not be laid upon the fact that the petitioner did not return any income for 1933." There is not a syllable of evidence in the record to that effect.

The opinion states (R. 71) "until the date of the Chancery Court decree, the petitioner had no unconditioned and unqualified right to receive the stock or its equivalent." The undisputed evidence shows that petitioner had such a right.

The case of *North American Oil Consolidated* v. *Burnet,* 286 U. S. 417, cited in the opinion (R. 71), sustains petitioner's position here rather than that of respondent, petitioner having been absolutely entitled to the stock as early as 1931, and surely in 1932 or 1933. In other words, as stated in the *Liebes* case, petitioner had a *reasonable expectancy as early as the year* 1931 that its right to the stock would be converted into money or its equivalent. The final decree of the Muskegon Court affirmed the right of petitioner to thirty-five per cent (35%) of the stock of Michigan Central by imposing a liability on faithless fiduciaries (Wrather, Maguire, Caldwell and their nominees).

In the case of *Brunton* v. *Commissioner,* 42 Fed. (2) 81, the taxpayer gave to a purchaser a written option to

purchase certain certificates for shares of stock, said option to be exercised not later than December 20, 1921. Before December 20, 1921, the taxpayer learned that the Congress would probably amend the law so as to reduce taxation on incomes for the following year. The option was permitted to lapse on December 20, 1921, and a new contract was drawn on that date to be consummated on March 28, 1922. The certificates were immediately delivered to the purchaser and in blank, but with the stipulation that until full payment therefor was made they should not be "registered and transferred upon the transfer books." The cash for the certificates was paid March 28, 1922. The Commissioner held that a profit accrued to the taxpayer in 1921 and levied an additional assessment which was upheld by the Board of Tax Appeals. The taxpayer objected. The court said on page 82:

> "To succeed it was necessary for appellant (taxpayer) to show before the Board of Tax Appeals, as well as here, that appellee (Commissioner) erred in making the additional assessment, and the burden was, therefore, upon her to prove the cash basis, if by her that was deemed to be a material consideration. (Citing cases.) Hence, presuming, as we must, that the accounts were kept upon an accrual basis, there would seem to be little room for doubt of the propriety of the assessment, for, if we accept appellant's theory of the transaction of December 20, the decedent acquired in 1921 the absolute obligation of Levee to purchase these certificates at a price to be adopted by appellee, as the basis for his computation of the tax which obligation was secured not only by the large amount of United States Liberty bonds and a promissory note, but by the full value of the certificates themselves. * * * Here the liability of the vendee for the purchase price was unconditional, the performance of this unconditional obligation was abundantly secured, as it was created in 1921."

The order of the Board of Tax Appeals was affirmed.

In the case at bar, Wrather's agreement to give petitioner a 35 per cent interest in the refinery whenever profits from the operation thereof amounted to $75,000.00 *was unconditional.* Said profits did amount to far more than $75,000.00 long prior to 1935.

Finally, in the case of *Spring City Foundry Co.* v. *Commissioner,* 292 U. S. 183, this court said on pages 184 and 185:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right to receive* and not *the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."* (Italics ours.)

In the above case this court affirmed the opinion of the Circuit Court of Appeals which had previously reversed the decision of the Board of Tax Appeals in the case of *Commissioner of Internal Revenue* v. *Spring City Foundry Company,* 31 B.T.A. 1246.

In the case of *Liebes* v. *Commissioner,* 90 Fed. (2) 932, the Court refused to hold that the petitioner there kept its books on an accrual basis because there was no proof of that fact in the record (page 934).

On page 935 the Court cited and approved the rule announced by the Sixth Circuit that a recovery for damages for injury to a taxpayer's business is "in effect a return of capital" or "a loss of capital investment."

It is an undisputed fact that in 1933 the interest of Petitioner in the Michigan Central Refining Company or the Roosevelt Oil Company was reasonably worth $90,000.00, to all of which Petitioner was entitled to in the year

1933. It received in settlement during the year 1935, the net sum of $53,146.52 (R. 30).

CONCLUSION.

The amount received in settlement constituted compensation for destruction of petitioner's intangible or incorporeal assets—no profit—a mere restoration of a corporate asset—a penalty imposed upon faithless fiduciaries. Furthermore petitioner's right to the Michigan Central stock accrued in 1933, it having kept its books on the accrued basis.

Because a pronouncement by this Court of the true principles of law to govern the decision of similar cases should materially decrease the amount of litigation, relieve the burden of the courts below, as well as that of this Court, and because injustice has been done to this Petitioner below, it is submitted that the granting of the petition in this case would be of sufficient public importance to warrant such action by this Court. It is therefore respectfully suggested that the writ should be granted.

Respectfully submitted,

HARRY C. KINNE,
Attorney for Swastika Oil Company.

MICHAEL J. SPORRER,
Of Counsel.

No. 109

In the Supreme Court of the United States

OCTOBER TERM, 1942

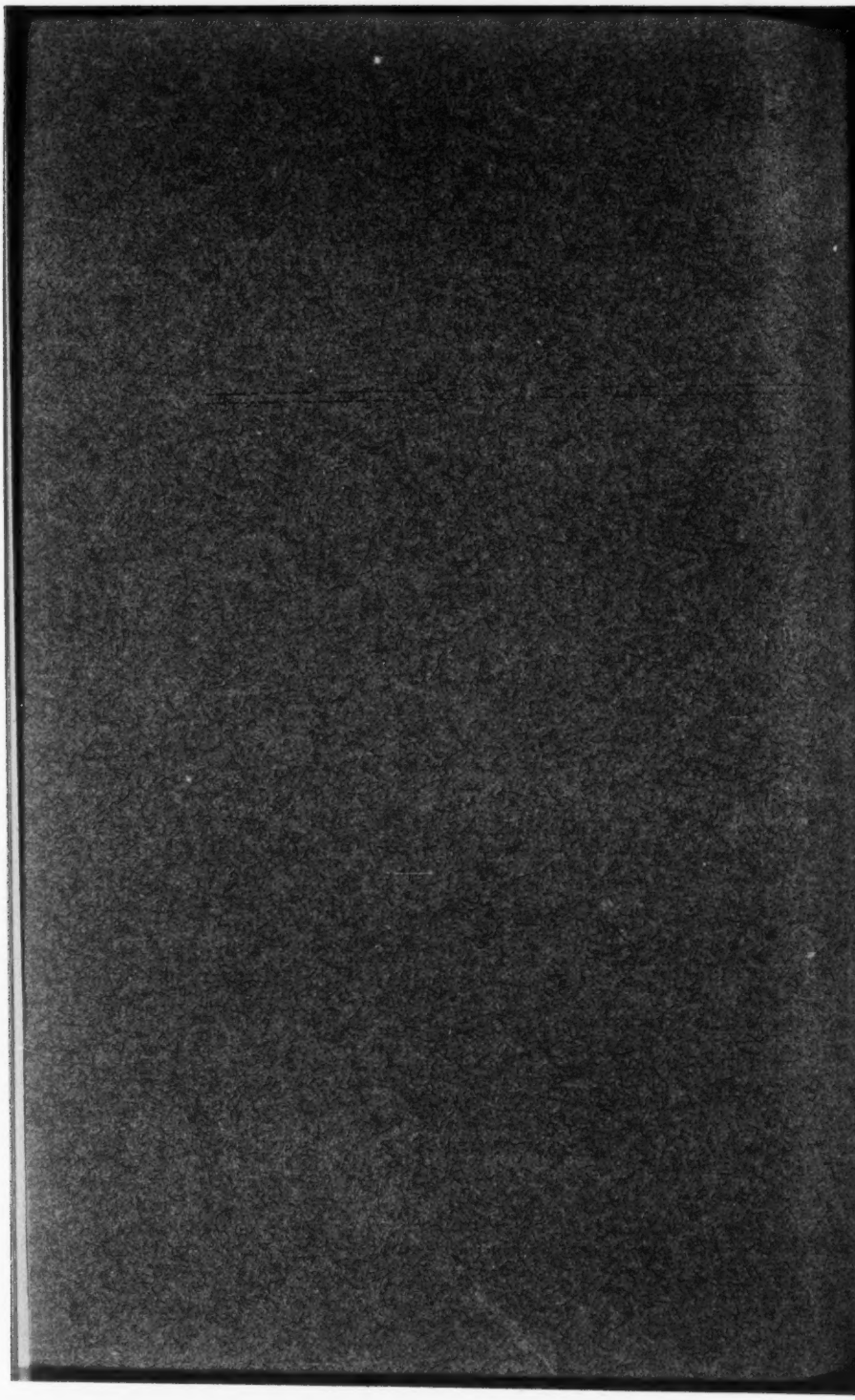
SWASEEKA OIL & GAS COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION



INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute and regulations involved	2
Statement	3
Argument	7
Conclusion	10

CITATIONS

Cases:

Arcadia Refining Co. v. *Commissioner*, 118 F. (2d) 1010 — 7
Central R. Co. v. *Commissioner*, 79 F. (2d) 697 — 8
Commissioner v. *Central United Nat. Bank*, 99 F. (2d) 568 — 9
Commissioner v. *Southeastern Express Co.*, 56 F. (2d) 600 — 9
Dougherty's Sons, J. A., v. *Commissioner*, 121 F. (2d) 700 — 9
Farmers' & Merchants' Bank v. *Commissioner*, 59 F.(2d)912 — 8
Helvering v. *Estate of David Davies, by Mabel L. Davies, Executrix*, No. 118, October Term, 1942 — 9, 10
Hort v. *Commissioner*, 313 U. S. 28 — 7
Liebes, H., & Co. v. *Commissioner*, 90 F. (2d) 932 — 7
Lucas v. *American Code Co.*, 280 U. S. 445 — 9, 10
North American Oil v. *Burnet*, 286 U. S. 417 — 9, 10
United States v. *Safety Car Heating Co.*, 279 U. S. 88 — 7, 9, 10

Statute:

Revenue Act of 1934, c. 277, 48 Stat. 680:

Sec. 22 — 2
Sec. 41 — 2
Sec. 42 — 3

Miscellaneous:

Treasury Regulations 86, Art. 42-1 — 3

467796—42

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 109

SWASTIKA OIL & GAS COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals is reported in 40 B. T. A. 798. The opinion of the Circuit Court of Appeals (R. 67–71) is reported in 123 F. (2d) 382.

JURISDICTION

The decree of the Circuit Court of Appeals was entered November 6, 1941 (R. 67). A petition for rehearing was denied March 3, 1942 (R. 81). The petition for writ of certiorari was filed on June 1, 1942. The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the net amount received by the petitioner upon the settlement of a law suit which it had won in the trial court constituted income.

2. If so, whether the petitioner, being on the accrual basis, is subject to tax on such sum in the year when the trial court rendered its decision and the compromise was effected and the payment was made, rather than in the year when the contractual right which was the basis of the suit arose.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 22. GROSS INCOME.
>
> (a) *General definition.*—"Gross income" includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> * * * * * *
>
> SEC. 41. GENERAL RULE.
>
> The net income shall be computed upon the basis of the taxpayer's annual account-

ing period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *.

* * * * *

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 42–1. *When included in gross income.*—* * *. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. * * *

STATEMENT

The facts as found by the Board of Tax Appeals may be summarized as follows:[1]

[1] The opinion of the Board (40 B. T. A. 798) does not appear in full in the printed record, but those portions of it which contain the pertinent findings are quoted at R. 58–61.

Petitioner is a corporation engaged in the production and sale of oil and gas in Muskegon County, Michigan. On April 19, 1929, petitioner entered into a contract with J. D. Wrather whereby the latter agreed to build an oil refinery in the vicinity of lands covered by certain oil and gas leases owned by petitioner. It was proposed that a corporation would be organized to operate the refinery. Petitioner agreed to sell to Wrather or to the corporation at a specified price and for a period of two years (extended by supplemental agreement to three years) certain minimum quantities of oil if and when produced at its wells. The contract further provided that when the earnings of the refinery should become equal to the cost of its construction, which by supplemental agreement was fixed at $75,000, petitioner would be assigned a thirty-five percent interest in the refinery or, if the refinery was operated by a corporation, thirty-five percent of its capital stock (R. 58).

The refinery was completed during 1929 and until about April 30, 1930, was operated by a newly organized corporation called the Michigan Central Refining Company, which had capital stock consisting of 30,000 shares of the par value of $10 per share. On or about April 30, 1930, the directors and principal stockholders of the company fraudulently conveyed and assigned, without adequate consideration, all of the company's assets to another corporation, the Roose-

velt Oil Company, which they had organized without petitioner's knowledge or consent. Thereafter, the refinery was moved to Mt. Pleasant, Michigan, where it was operated by the Roosevelt Oil Company. The Michigan Central Refining Company was dissolved (R. 59).

On May 19, 1931, petitioner brought suit in the Circuit Court of Muskegon County, Michigan, against the Michigan Central Refining Company, its individual stockholders and directors, the Roosevelt Oil Company and others. The complaint (see R. 32–36) alleged, *inter alia*, that the conveyance of the assets of the Michigan Central Refining Company to the Roosevelt Oil Company and the dissolution of the former company were fraudulent and invalid, and that under its contract with Wrather petitioner was entitled to thirty-five percent of the stock of Michigan Central Refining Company and to thirty-five percent of the profits realized from the operation of the refinery. The complaint prayed *inter alia,* that the defendants account to petitioner, that the dissolution of the Michigan Central Refining Company be cancelled and declared void, and that the individual defendants be ordered to issue thirty-five percent of the stock of the company to petitioner. The defendants filed an answer (see R. 39–43) in which they denied that sufficient earnings had been realized to pay for the cost of the refinery. They alleged also that petitioner had

failed to provide the refinery with oil as required by the contract (R. 59, 68–69, 71).

On January 23, 1935, the state court handed down an opinion (R. 43–48) in which it upheld most of the petitioner's allegations. The court decreed (R. 48–52) that the dissolution of the Michigan Central Refining Company and the sale of its assets were null and void and ordered that the company be reinstated and that there be assigned to it all of the assets of the Roosevelt Oil Company. It was further ordered that there be issued to the petitioner 10,480 shares of the capital stock of the Michigan Central Refining Company, and that an accounting of the profits of that company and the Roosevelt Oil Company be made to determine the amount thereof to which petitioner was entitled under the contract (R. 59–60).

The defendants prepared to take an appeal but later agreed to settle the case out of court. Pursuant to such agreement petitioner in September 1935 received a cash payment of $80,000 in full settlement of its claims. Petitioner had incurred legal expenses of $26,853.48 in connection with the suit, leaving a net recovery of $53,146.52. Petitioner keeps its books upon the accrual basis and makes its income tax returns on the basis of a fiscal year ending October 31 (R. 60–61).

In his deficiency notice the respondent included the net amount of $53,146.52 in petitioner's

gross income for the taxable year ended October 31, 1935. The Board of Tax Appeals upheld this determination and found deficiencies in income tax and excess profits tax for such year in the amounts of $6,953.32 and $2,492.18, respectively (R. 57). The Circuit Court of Appeals affirmed the Board's decision (R. 67–71) and denied a petition for rehearing filed by petitioner (R. 81).

ARGUMENT

1. The court below correctly held that the net amount received by petitioner in settlement of its suit constituted income. The suit was founded on the failure to deliver the shares of stock of Michigan Central Refining Company to petitioner pursuant to the contract under which it, in turn, was obligated to sell oil. If the shares had been delivered as promised, they clearly would have constituted income. Consistently, therefore, the net amount received in the settlement likewise was income. *United States* v. *Safety Car Heating Co.*, 297 U. S. 88; *Hort* v. *Commissioner,* 313 U. S. 28, 30–31; *Arcadia Refining Co.* v. *Commissioner,* 118 F. (2d) 1010 (C. C. A. 5); *H. Liebes & Co.* v. *Commissioner,* 90 F. (2d) 932 (C. C. A. 9).

Since petitioner's claim was based on its contractual right to the stock which had been promised it as part of the consideration for its undertaking to sell oil, the amount received in the settlement may not be viewed either as compensa-

tion for a loss of or injury to capital or as a penalty imposed by law against faithless fiduciaries. Accordingly, the decision does not, as contended by petitioner (Pet. 6–8, 12–20), conflict with the prior decision of the court below in *Farmers' & Merchants' Bank* v. *Commissioner,* 59 F. (2d) 912, or with the decision of the Circuit Court of Appeals for the Third Circuit in *Central R. Co.* v. *Commissioner,* 79 F. (2d) 697.

2. Petitioner contends (Pet. 8, 23–35) that if the amount received in the settlement was income, it accrued in 1933 rather than in 1935 when actually received. The grounds of this contention are that petitioner kept its books on the accrual basis and that under the contract it became entitled to the stock in 1933 by virtue of the fact that in that year the cost of the refinery became fully paid for by its earnings. However, in the suit instituted by petitioner in 1931 the defendants denied that the earnings of the refinery were as large as alleged by petitioner; they asserted also that petitioner had breached the contract by failing to sell oil as agreed (R. 40, 42). Petitioner's right to the stock, therefore, was in controversy and, as held by the court below (R. 71), did not become definite until the decision of the state court early in 1935. Not until then could its claim be said to have accrued, especially in the absence of any evidence that it had accrued the estimated value of the stock on its books or had returned it as income for 1933 (see R. 70–71).

Lucas v. *American Code Co.*, 280 U. S. 445; *North American Oil* v. *Burnet*, 286 U. S. 417; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88; *Commissioner* v. *Southeastern Express Co.*, 56 F. (2d) 600 (C. C. A. 5).

Subsequent to its decision in the instant case the court below held in *Davies Estate* v. *Commissioner*, 126 F. (2d) 294, that a taxpayer who kept his books on the accrual basis was entitled to deduct processing taxes from his income for 1935 notwithstanding that he had obtained an injunction against the collection of the taxes and that he never paid them. In arriving at this result the court followed its own earlier decision in *Commissioner* v. *Central United Nat. Bank*, 99 F. (2d) 568, and the decision of the Circuit Court of Appeals for the Third Circuit in *J. A. Dougherty's Sons* v. *Commissioner*, 121 F. (2d) 700, which took the view that liabilities for taxes levied by the sovereign possess a definiteness and finality not possessed by ordinary fiscal obligations. The court in its opinion did not refer to its decision in the instant case and no conflict is asserted by petitioner.

The Government has filed a petition for writ of certiorari to review the decision in the *Davies* case. *Helvering* v. *Estate of David Davies, by Mabel L. Davies, Executrix*, No. 118, October Term, 1942. The granting of the petition in that case, however, would not call for similar action here. The decision in the *Davies* case is inconsistent

with accepted principles of accrual accounting and presents a factual pattern that is present in a large number of pending cases involving a considerable amount of revenue. The decision in the instant case, on the other hand, is in accord with accepted principles, as applied by this Court in the *American Code Co., North American Oil,* and *Safety Car Heating Co.* cases which involved circumstances analogous to those herein.

CONCLUSION

The decision of the court below is correct and the petition should be denied. In the event, however, that the petition is granted because of similar action in the *Davies* case, the writ should be limited to the second question presented.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
LOUISE FOSTER,
Special Assistants to the Attorney General.

JUNE 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942